

SUPERIOR COURT OF ARIZONA  
MARICOPA COUNTY

TX 2004-000068

08/23/2006

HON. THOMAS DUNEVANT, III

CLERK OF THE COURT  
S. Brown  
Deputy

SOUTHWEST AIRLINES CO

PAUL J MOONEY

v.

ARIZONA STATE DEPARTMENT OF  
REVENUE, et al.

FRANK BOUCEK III

MINUTE ENTRY

Defendants' Motion for Partial Summary Judgment Re Assessability of Flight Software and Plaintiff's Cross-Motion for Partial Summary Judgment have been under advisement. The Court finds and rules as follows:

The parties have submitted reciprocal Motions for Summary Judgment addressing the legality of a portion of the valuation by the Department of Southwest's aircraft, specifically, that portion attributable to avionics software. The issue turns on the interpretation of *Honeywell Information Systems, Inc. v. Maricopa County*, 118 Ariz. 171 (App. 1977), and whether it applies to the avionics software in question. As this is purely a question of law, summary judgment for one party is appropriate.

Southwest takes the position, both in its motion and in its response to the State's motion, that *Honeywell* lays down a *per se* rule that computer software must be treated as intangible property distinct from its associated hardware, and that the statute is not sufficiently explicit to overcome the traditional rule that intangible property is not subject to tax. The State objects to the characterization of software as intangible property, and further argues that, regardless of its tangibility, the statutes permit the taxation of avionics software and that the objections raised in the Arizona case law to taxation of intangibles are met by the statutory scheme. The Court declines the Department of Revenue's invitation to overrule *Honeywell's* clear holding that

SUPERIOR COURT OF ARIZONA  
MARICOPA COUNTY

TX 2004-000068

08/23/2006

software is intangible property, and addresses whether intangible software is subject to the aviation property tax statutes.

The statutes

A.R.S. § 42-14254(A) requires the Department of Revenue to determine the full cash value of all flight property operated in the state. A.R.S. § 42-14251(6) defines “flight property” as “all airline company aircraft of the types used in the state”; paragraph 2 of the same statute defines “aircraft” as “any device that is used or designed for navigation or flight through the air.” Under the statute, the entire “aircraft” is taxable. The statute makes no distinction between tangible and intangible parts: if the software is part of the “aircraft,” and only then, it is taxable.

Does *Honeywell* forbid taxation of software entirely?

There are two distinct holdings in *Honeywell*. The first is that “computer software is intangible property and, as such, should be excluded in determining the value of tangible computer equipment.” *Id.* at 173. The second is that, because it is intangible property, no tax can be levied against software. *Id.* (citing *Brophy v. Powell*, 58 Ariz. 543 (1942), etc.) Neither holding alone is sufficient to invalidate the tax. The *Honeywell* court recognized that no *per se* bar exists to the taxation of intangibles. Rather, the case law on which *Honeywell* relied held that no proper provision had been made for the equalization and collection of taxes against intangible property. *Id.*; *Maricopa County v. Trustees of Arizona Lodge No. 2, F. & A. M.*, 52 Ariz. 329 (1938). The statutory scheme here, if it is assumed that the avionics software, whether part of the computer running it or not, is part of the aircraft, satisfies the earlier objections. As *Arizona Lodge* held, a property tax against intangibles fails in principle because of the possibility that the intangible itself cannot be seized and the taxpayer lacks sufficient real property to pay the tax. *Id.* at 336-37. Here, the statute provides both that the tax is a debt of the airline company (in contrast to *Arizona Lodge*, which held that a property tax under the law at that time was not a personal debt) and that the aircraft as a whole is subject to a lien and ultimately to seizure if the tax is not paid. Avionics software, by its nature, exists within essentially all aircraft and only within aircraft; there is no realistic commercial possibility that one might own taxable avionics software without an aircraft to levy it against.

*Arizona Lodge* further held that a tax on intangibles was invalid unless the taxpayer was provided an opportunity to appeal the assessor’s valuation, without regard to the availability of sufficient real property to cover the tax. *Id.* at 335-36. However, *Brophy v. Powell*, *supra* at 554-55, makes it clear that, if such recourse is available, the tax is not invalid on that ground. Here, the statute provides the right of administrative review and appeal, followed by access to the courts for relief. A.R.S. § 42-14256. Moreover, the basis of the tax leaves little discretion

SUPERIOR COURT OF ARIZONA  
MARICOPA COUNTY

TX 2004-000068

08/23/2006

for the assessor: the capitalized acquisition cost or manufacturer's list price, reduced by a prescribed formula for depreciation. (As a corollary, it does not matter if the manufacturer charges a separate line amount for the software, any more than it would if a separate amount were charged for some physical part of the plane. It is not likely that any commercial aircraft would be sold or accepted without avionics software, so the attempt to exclude it from the price would be a mere economic fiction.) Accordingly, there is no reason why Southwest's discrimination claim, that avionics software is improperly taxed because other software is not taxed, cannot be addressed in that manner.

Southwest makes a more subtle argument, conflating the two *Honeywell* holdings. The avionics computer hardware, it concedes, is part of the aircraft and properly taxable. However, it finds in *Honeywell* a rule that software is *per se* intangible property distinct from the computer, and therefore not within the statute. It does not appear that Southwest is making the argument that an intangible can never be part of a tangible item, or that intangibles by their nature cannot be properly valued, so that even an express declaration by the legislature would be insufficient to overcome *Arizona Lodge* and its progeny. These positions lack support in the case law: the courts have consistently recognized that intangibles can be, and in principle should be, taxed. Rather, it argues that the evidence of legislative intent is insufficient to overcome decades of tradition that intangibles are not taxed. This position goes beyond what *Honeywell* requires.

Plaintiff's argument that the legislature, charged with awareness of existing case law, should have stated more explicitly that software was taxable as part of the aircraft is not embraced by the Court. When the present statute was enacted in 1997, it was common knowledge that avionics software is an essential part of modern commercial flight. The legislature did address *Arizona Lodge* by expressly declaring the tax on the aircraft to be a debt of the taxpayer airline. A.R.S. § 42-14257(1). In light of these factors, the argument based only on the tradition of non-taxation of intangibles is not sufficiently compelling to overcome the language of the statute that the entire aircraft, without exclusions, is subject to tax.

What software is taxable with the device containing it?

The *Honeywell* court's exact words, *supra* at 173, were, "There is little doubt that computer software is intangible property and should be excluded in determining the value of tangible computer equipment." *Honeywell* dealt with multipurpose computers, specifically mainframes, though the principles from that case apply with as much or more force to personal computers. When *Honeywell* was handed down in 1977, the computer was evolving from a computational device limited to a few functions to the modern multipurpose platform with no inherent purpose, intended to be used to perform any of myriad tasks required by its owner. The unbundling of software was a manifestation of this evolution. What *Honeywell* did not address, most likely because such technology was in its infancy, was *equipment, not itself a computer, but*

SUPERIOR COURT OF ARIZONA  
MARICOPA COUNTY

TX 2004-000068

08/23/2006

*containing and relying on for its functionality computer hardware and software.* Today, software is integrated into devices from airplanes and cars down to humble microwave ovens and pocket calculators. Exclusion of the software value from the value of these objects can lead to nonsensical results. There would remain considerable taxable value in an airplane or a car if the value of its embedded software is somehow calculated and excluded, but a calculator would have only such scrap value as a few ounces of hard plastic might bring. By Southwest's argument, the legislature would be effectively barred from imposing a personal property tax on calculators. Even ignoring such a *reductio ad absurdum* case in which the operation of the software is the entire *raison d'être* of the device, exclusion of the software would create a valuation nightmare. What is the value of the software within a microwave oven? How can an oven with a button for baking a potato be equalized with one having a frozen pizza button instead, if the assessor is required to ignore the package price charged by the free market?

The distinction suggested by Southwest at oral argument between operating software and application software leads to a dead end. It is not only underinclusive for the reasons outlined above, but overinclusive as applied to the multipurpose computers that were the subject of *Honeywell*. In the personal computer world, there are several operating system packages available: Windows, Linux, Mac OS, and so on. Other operating systems exist for mainframe computers. While some operating system is essential to the functioning of a multipurpose computer, the consumer has a reasonable choice; no *particular* operating system is indispensable. This attempted distinction therefore applies *Honeywell* beyond its fact pattern, but fails to apply it fully within its fact pattern. Each operating system is based, at several removes, on assembly language, which instructs the computer how to perform the commands it will find in higher-level languages. There are thus three types of software: assembly language, which is essential in that form, operating software, which is essential in some form, but with a choice, and application software, which is dependent entirely upon the needs of the user. *Honeywell* does not distinguish among them. The language of *Honeywell* therefore cannot be taken literally as a bar to all inclusion of software integrated as an element of a greater whole.

To give effect to the holding of *Honeywell* within the reality of modern technology, it is necessary to shift the focus away from the software and onto the use intended for it by its owner. Discretionary software for multipurpose devices, the situation which the *Honeywell* court faced, is not taxable: this Court does not believe it necessary or proper to revisit that holding. However, software embedded into a non-computer device, regardless of whether the software is considered a tangible or an intangible part of that device, is properly considered part of the device. The Court now must determine where the avionics software falls under this reading of *Honeywell*.

SUPERIOR COURT OF ARIZONA  
MARICOPA COUNTY

TX 2004-000068

08/23/2006

Does *Honeywell* apply to avionics software?

The avionics computer used on Southwest's 737s ultimately has but one function: to operate the airplane. For the most part, this software is no different than that found in any 737, because it is based on the circuitry unique to the 737; other models of aircraft will have software to perform the same functions utilizing the specific circuitry of those models. There may be some individualization of the basic 737 software to Southwest, to permit the avionics computer to send data and respond to the multipurpose computers on the ground, but even this is an aspect of its overall function of processing data relevant to operating the plane.

Southwest's multipurpose computers could be deprogrammed (of everything above the level of assembly language) without any inherent loss in the value of the computers themselves or of Southwest's other property: programmed by their new owners, they could be used for any computing purpose. Deprogramming the avionics computer, without the assured availability of essentially identical 737 software, would not only render the avionics computer useless, but would result in a substantial – in the United States, likely a total – loss of the aircraft beyond its salvage value. While that portion of the software unique to Southwest can be (and for protection of trade secrets probably is) removed without substantially degrading the resale value, this is a small percentage of the total package, or even of the value of the software, insignificant in proportion to the capitalized acquisition cost or manufacturer's list price. *Honeywell* therefore does not require departure from the statutory language.

The avionics software, then, is properly considered part of the overall aircraft, which uses both hardware and software for its own functionality. It would therefore be pure artifice to separate the avionics software from the aircraft it operates. *Honeywell* does not require that result.

Ruling

The statute provides for taxation of the avionics software as part of the overall tax on the aircraft, and there is no bar to that assessment.

Therefore, IT IS ORDERED granting the Department's Motion for Summary Judgment re Assessability of Software is granted.

IT IS FURTHER ORDERED denying Plaintiff Southwest's Cross-Motion for Partial Summary Judgment.